Statement of Alice M. Rivlin
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before the
Committee on the Budget
United States Senate
July 20, 1977

Mr. Chairman and Members of the Committee:

My statement this morning covers several topics of importance to this Committee in its deliberations on the Second Concurrent Resolution on the Budget for Fiscal Year 1978. You already have copies of CBO's latest economic report, Recovery With Inflation, and the statement will begin with a summary of the economic outlook presented in that report and the comparison with some other views about the outlook. Next comes a discussion of factors that could affect the budget in 1978 and in later years, including spending reestimates, special employment programs, and the possible impact of new initiatives in the energy and social security areas. Finally, I will summarize a statement submitted to this Committee at the beginning of this month on the importance of making major budget decisions on a multi-year basis instead of one year at a time.

The Economic Outlook

The economic outlook has not changed significantly since the enactment of the First Concurrent Resolution on the 1978 Budget. Signs of more vigorous growth this past spring are being succeeded by some weakness in the

latest data. Averaging through these fluctuating indicators, CBO's projections show a slow narrowing of the gap between actual and potential output and a reduction of unemployment during 1977 and 1978, with the rate of inflation remaining high by historical standards.

Growth in real output (GNP in 1972 dollars) is projected as slowing from its recent 7 percent annual rate to a range of 3.6 to 5.1 percent during 1978. Growth in this range would be enough to reduce unemployment at a slow pace, to the 5.9 to 6.9 percent range at the end of 1978.

Consumer prices, which rose by 6.7 percent over the last 12 months, are projected to increase more slowly as food price increases moderate. An increase of 4.5 to 6.5 percent in consumer prices in 1978 is projected. The forecast is summarized in the table on the following page.

The assumptions underlying this forecast include:

- Food prices settling down to a 5 to 6 percent annual rate of increase after their recent fluctuation, and energy prices continuing to rise at a 10 to 12 percent rate;

- A slight shortfall in federal spending below the First Concurrent Resolution on the Federal Budget for Fiscal Year 1978;

TABLE 1. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1977-1978

	Levels				Rates of Change (Percent)	
	Actual		Projected			
	1976:4	1977:1	1977:4	1978:4	1976:4 to 1977:4	1977:4 to 1978:4
GNP (Billions of Current Dollars)	1,745	1,799	1,940 to 1,980	2,130 to 2,190	11.0 to 13.0	8.5 to 11.5
GNP (Billions of 1972 Dollars)	1,280	1,302	1,345 to 1,360	1,395 to 1,425	5.0 to 6.0	3.6 to 5.1
General Price Index (GNP Deflator, 1972 = 100)	136	138	144 to 146	152 to 155	6.0 to 7.0	4.5 to 6.5
Consumer Price Index (1967 = 100)	174	177	184 to 186	193 to 197	6.0 to 7.0	4.5 to 6.5
Unemployment Rate (Percentage Points)	7.9	7.4	6.6 to 7.2	5.9 to 6.9	--	--

- Growth in the broadly defined money stock (M2) near the upper end of the 7 to 9 1/2 percent target range recently announced by the Chairman of the Federal Reserve Board.

The forecast presented by the Carter Administration in its Mid-Year Budget Review is at the optimistic end of the CBO range with respect to growth. On unemployment, the Administration projects a rate of 6.6 percent at the end of this year, compared with the CBO range of 6.6 to 7.2 percent. At the end of 1978, the Administration projects an unemployment rate of 6.1 percent, compared with the CBO range of 5.9 to 6.9 percent. With respect to inflation, the Administration's projections are higher than the mid-point of the CBO range, but well below the upper end.

While the Administration remains relatively optimistic in its view of the outlook for economic growth, some recent economic news indicates weakening of demands. The unemployment rate rose from 6.9 to 7.1 percent between May and June and aggregate hours of production workers in the private nonfarm economy declined slightly. Retail sales have been unchanged for three months in current dollars, and have declined in constant dollars. If signs of weakness grow and the economy seems headed

to the low end of the CBO range or lower, then the Congress might wish to consider modifying the fiscal policy reflected in the First Concurrent Resolution on the Budget.

However, it would be quite premature to decide at this stage that the economy is headed toward the lower end of the CBO range. It is possible that what we are witnessing is a faulty statistical correction for normal seasonal variations. Seasonal correction is especially difficult when there are large fluctuations in the economy, as there have been in recent years. A significant part of the strength in early 1976, the weakness later in that year, and the strength in early 1977 could be a bias in seasonal adjustment procedures. This is particularly likely in the unemployment rate and could be affecting other data as well.

It should not, however, affect the industrial production index, which is seasonally adjusted by a different procedure from most other data--one which deliberately omits the influence of fluctuations during 1975 and 1976. The fact that the industrial production index continued to grow strongly in June, therefore, lends some support

to this view of recent economic statistics. If the view is correct, we would expect many economic indicators as presently adjusted to show a weak second half of 1977 followed by a strong early 1978.

Apart from seasonal adjustment, there are basic uncertainties about the economic outlook that statistics for one or two months cannot resolve. The future of business spending on new plant and equipment is one of them. The CBO projection of investment spending follows fairly closely the Commerce Department's survey of business plans for 1977 and projects an 8 percent rate of growth (in constant dollars) during 1978. Those with the more optimistic views of real growth prospects than CBO projections are counting on a major investment boom to develop sometime late in 1977.

Another key uncertainty about private demand is the saving rate. Consumers saved less than 5 percent of their current disposable income in the first quarter of this year, an extremely low rate influenced by the end of the Ford Motor strike, the large fuel bills due to cold weather, and a change in estate and gift tax laws. The CBO forecast projects a saving rate above the first-quarter rate but remaining in the 5 to 6 percent range

throughout the forecast period. Since 5 or 6 percent is substantially below the rates recorded in recent years, this is a fairly optimistic projection. Judgments in this area have to be tentative, however, since data revisions could alter significantly the recent level of saving rates.

Assumptions about monetary policy and the behavior of financial markets introduce additional uncertainty. The CBO forecast assumes that M2, currency plus demand and time deposits at commercial banks, will grow at the upper end of the target range recently announced by the Federal Reserve--7 to 9.5 percent per year--and that short-term interest rates will increase by about one percentage point over the next six quarters.

These financial assumptions involve two related risks. First, it is possible that the Federal Reserve will hold the growth of monetary aggregates below the upper end of the target ranges or that it will lower its targets from time to time, as suggested by Chairman Burns of the Federal Reserve Board in recent testimony. The second risk involves the possibility that the largely unexpected stability of interest rates in the last two years was an historical aberration and that even the

rate of monetary growth projected by CBO would involve a sharper rise in short-term interest rates than the moderate upward trend in our forecast.

Budget Goals for 1981

Uncertainties multiply as we attempt to look beyond 1978. Nevertheless, it is important to address as clearly as possible the issue of prospects for moving simultaneously toward a balanced budget and a low unemployment rate over the next four or five years.

In an earlier analysis of this issue, CBO concluded that to reach an unemployment rate of 4.5 percent and a balanced budget by 1982 would require a level of non-federal demand which is strong by historical standards. With only moderate nonfederal demands, it would be necessary to settle either for a continuing deficit or for a higher unemployment rate.

We know of no reason to alter these conclusions. According to CBO's latest calculations, strong nonfederal demands, including a major investment boom in 1979 and 1980, would make it possible to reach an unemployment rate slightly below 5 percent by 1981, in combination with a balanced federal budget with outlays equal to 21 percent of GNP. This would provide budgetary room for

new spending initiatives (above current policy) amounting to $15 or $20 billion in 1981. Without an investment boom, even if other private demands are strong, achieving the same unemployment goal would require continuing deficits in the neighborhood of $50 billion through 1981. Since GNP is projected as rising during these years, roughly constant deficits would represent a declining fraction of GNP.

The Persistence of Inflation

Almost all projections of the economy over the next few years include a continuation of inflation at rates which are high by historical standards. The CBO report on the economy just issued concentrates on the puzzle of continuing inflation in a slack economy, and addresses the question of whether there is any prospect of quick relief from historically high rates of inflation.

The principal reason why inflation rates continue high is that, once inflation is anticipated as a continuing feature of economic life, it gets built into a great many economic contracts and decisions and develops very strong momentum. During the last decade, inflation has become embedded strongly in our economic machinery. The rapid spread of cost-of-living-adjusted labor

contracts, the reflection of inflationary expectations in a broad spectrum of interest rates, and the automatic linking of major federal entitlement programs to consumer price increases are a few important examples.

There are no costless ways to reduce inflation quickly. Contractionary macroeconomic policies reduce inflation eventually but carry a grave risk of causing recession. A fiscal policy restrictive enough to take 1 percentage point off the rate of inflation three years from now is estimated to cost 1.2 percentage points more in the unemployment rate--an addition of more than a million to the number of unemployed workers--in the first year of the policy, and continuing serious unemployment impacts for several years thereafter.

Wage and price guidelines or controls have often succeeded in reducing inflation while they have been in effect. Evidence suggests, however, that part of the gain in lower inflation rates is only temporary and that there are often substantial associated problems of evasion, inefficiency, and inequity. Policies to reduce price increases in individual sectors--control of hospital costs or holding down increases in the minimum wage, for example--can lead to modest improvements in

the inflation outlook but are strongly resisted by the groups whose incomes might be adversely affected.

Finally, a number of tax incentive and related schemes to penalize inflation or reward wage stability may offer a promising strategy, but must be rated uncertain because they are untried. Further thought and possibly experimentation with these newer ideas and perseverance on special steps for individual sectors may yield some benefits. As a basis for budget planning for 1978, the realistic outlook is for no more than a slow unwinding of the current rate of inflation.

Status of the 1978 Federal Budget

We have just completed a comprehensive review of the 1978 budget estimates based on the OMB Mid-Session Review submitted on July 1, analysis of actual spending trends to date, and programmatic information provided by other federal agencies. As a result of this review, we are lowering our scorekeeping estimates of 1978 outlays by over $5 billion. This revised estimate is based on the economic assumptions used for the First Budget Resolution for 1978; using the new CBO economic forecast instead would result in a downward revision of $4 billion rather than $5 billion. Our revenue estimates remain essentially unchanged.

Scorekeeping reestimates for 1978 will be incorporated into the next Senate Budget Scorekeeping Report to be issued on July 25. The major net changes are shown in Table 2 on the following page.

TABLE 2. MAJOR OUTLAY REESTIMATES FOR FISCAL YEAR 1978 IN BILLIONS OF DOLLARS a/

Major Items	Outlays
Unemployment Compensation	-1.1
Interest on the Public Debt	-0.9
OCS Rents and Royalties	-0.7
Social Security	0.7
Employer Share, Employee Retirement	-0.6
Employment and Training Assistance	-0.5
CCC Farm Price Supports	0.4
Community Development Grants	-0.4
TVA Fund	-0.4
Strategic Petroleum Reserve	0.4
Temporary Employment Assistance	-0.3
ERDA	-0.3
Public Assistance (Medicaid and AFDC)	-0.3
Local Public Works	-0.2
All Other, Net	0.1
Total	-4.1

a/ Based on CBO economic forecast as described in Table 1.

Although we have not yet completed our review of 1977 spending estimates, we expect to make a number of downward adjustments here as well that will bring total outlays into the $403 to $405 billion range. This would be $4 to $6 billion below the third budget resolution level (as amended), and $1 to $3 billion below the level estimated by OMB in its July 1 Mid-Session Review.

These continuing "shortfalls" in federal spending below the budget resolution levels have been included in our current economic forecast. If 1978 spending were to fall much below $455 billion, then our projected growth rate may have to be lowered somewhat.

While there are a number of different reasons for overestimates of spending, it does appear that federal agencies are generally overly optimistic about outlays for new program initiatives and major expansions of existing programs. Thus, the Administration's 1978 outlay estimates should be regarded more as a plan than a forecast or prediction of what actually will occur. The CBO scorekeeping tabulations, on the other hand, are designed to forecast actual spending.

Delays in enactment and implementation of the economic stimulus program have led to some of the shortfalls in spending. The Economic Development Administration (EDA) has $6 billion in budget authority for public works in fiscal year 1977, but we estimated outlays of only $0.7 billion in fiscal year 1977 and $2.9 billion in fiscal year 1978. EDA reports that it will not complete project selection for the $4 billion in the economic stimulus program until August 15.

The Department of Labor reports that roughly 40,000 jobs per month have been added to public service employment in the first two months of the expansion under the economic stimulus program. In the light of this job growth, it has revised its goal of reaching 725,000 jobs by the end of calendar year 1977 to the end of February 1978.

New Budget Initiatives

The Carter Administration proposals with respect to energy and with respect to the social security system would, if enacted, have minor impact in 1978 and more important impacts in 1979 and later years. The effects of the energy program were analyzed in a CBO report issued the first week of June. At that time we estimated that the Carter energy plan would add about 1.6 percent to the level of consumer prices by 1980, or about half a percentage point per year to the rate of inflation from 1978 to 1980. We also estimated that the Carter proposals are likely to reduce constant dollar GNP by no more than 0.7 percent by the end of 1980. Unemployment is expected to be no more than 0.2 percentage points higher than it would be without the

proposals by 1980. The overall conclusion of our study is that the strategies proposed by the Administration are generally effective in reducing America's energy use and dependence on oil imports. We believe that the Administration's estimates of the energy savings attributable to the plan are slightly optimistic--but enactment of the plan is likely to result in oil equivalent energy savings of at least 3.5 million barrels per day by 1985.

Recent Congressional action on the energy package has raised the possibility that prices for new natural gas will be deregulated rather than controlled at a level of $1.75 per thousand cubic feet, adjusted thereafter for increases in other fuel prices, as proposed by the Administration. Assuming that prices for new gas would, in the short run, rise well above the BTU equivalent for oil--to about $4.00 per thousand cubic feet--we have estimated that deregulation of new natural gas would increase consumer costs for new gas by an average of about $10 billion per year between now and 1985. Although estimates of additional production resulting from deregulation are speculative, we do not believe that deregulation would increase production by more than one trillion cubic feet per year--the equivalent of about one-half million barrels per day--by 1985.

Like the Carter energy proposals, deregulation would probably add to the overall inflation rate and slightly reduce the growth of output for a few years. We estimate that the Consumer Price Index would rise by about half a percent per year more with deregulation than without it, during the years 1978-1985. The effect on output and unemployment depends on the investment response of gas producers which is extremely hard to forecast, but it seems likely that deregulation would add two to four tenths of a percentage point to the unemployment rate by 1980.

The proposals of the Carter Administration for financing social security are described in a forthcoming CBO background paper that reviews the short-term and long-term financing alternatives. In general, the Administration proposals appear to provide ample financing for expected social security expenditures over the next 25 years, but not enough to fund the bulge in expenditures after the turn of the century. Although the financing package includes a proposal for correcting the current method of determining benefits--a method that leads to an overadjustment for inflation--this "decoupling" proposal provides for little relief from rising expenditures in the short term and would still provide for a very large

increase in benefits in the long term. The Administration has not as yet proposed any other broad reform in the structure or coverage of retirement of disability benefits. Without any such reforms, expenditures in the future are projected to consume ever larger amounts of the nation's resources. If we do not take a hard look at the expansion of benefits and eligibility for benefits that has taken place piecemeal, to see if we do in fact wish to use the social security system in this way, then there is no choice but to raise the revenues that will be required by the present system.

The additional financing proposed by the Administration will largely come from increases in payroll taxes. These taxes differ from traditional policy chiefly because of the disproportionately large share levied on employers of workers with earnings above the taxable maximum. Firms, however, are likely to shift the taxes to consumers, in the form of higher prices, and to workers, in the form of lower wage increases, than would otherwise have occurred, with a likely net effect of a small dampening of growth in the economy.

Although tax increases are the primary tool of the Administration's funding proposals over the long term, they are to be gradually introduced, starting in 1979.

In 1978, the Administration is relying primarily on a transfer from general revenues to boost the social security trust funds. This transfer is the first installment of a total of $14 billion to be given to social security over a three-year period. The transfer is intended as a compensation for the reduction in social security revenues that could be attributed to the depressed employment resulting from the recession, during the period 1975-1978. The transfer to the trust funds from general revenues will have no immediate effect on the economy. We do not, then, foresee any consequences of the Carter social security package for the 1978 budget. The proposed transfer from general revenues together with the additional proposal for a transfer from the hospital insurance trust funds would prevent the combined OASDI balances from falling below one-third of a year's outlays through 1978 at least. This would provide time for a thorough consideration of the future structure of social security, including the benefit side as well as alternative sources of funding.

Advance Budgeting

To conclude this statement, I would like to summarize the major recommendations of a statement I submitted to this Committee at the beginning of this month on the

subject of advance budget planning. Mr. Chairman, with your permission, I will submit for the record the complete statement and the report prepared by the Congressional Budget Office pursuant to section 502(c) of the Congressional Budget Act. The report is quite short--only sixteen pages--and unique for the CBO in that the law requires us to make recommendations.

These last three years have seen remarkable and laudable change in the methods by which the Congress makes its budgetary decisions. The justifiable satisfaction with these achievements should not, however, keep us from acknowledging that some of the goals envisioned when the Congressional Budget Act was passed are yet to be fully realized. The Congress still has difficulty debating issues of major national budgetary priorities, especially competing priorities on the domestic scene.

These difficulties are likely to continue so long as the Congressional budget process concentrates primarily on the upcoming fiscal year. Most of the federal spending for next year--probably at least 70 percent of it--will occur because of decisions of past Congresses, not of this Congress; and while the other

30 percent will nominally be decided this summer in the appropriations cycle, practically all of it is foreordained just by the sheer momentum of the government.

Right now, however, spending for fiscal year 1979 is not so much the prisoner of the past and less foreordained than that for fiscal year 1978, and the spending for fiscal year 1980 and future years even less so. This session of the Congress will likely have more impact on the 1982 budget, whether intentional or not, than the Congress that meets four years from now. But the budget procedures now in use cause this session to focus on a year--fiscal year 1978--about which it can do very little except at the margin, while it virtually has to ignore a future year about which it could do a lot.

The kinds of problems just described could be ameliorated if the Congress were to begin more formally to make spending and taxing decisions in the light of where it wants to be in some year beyond the upcoming fiscal year. That would mean deciding now what the outyear goals are to be.

Debate on advance targets provides an opportunity to consider such outyear goals. By setting advance targets, the Congress can set the outlines of major policy.

It can establish a budget framework for the future--a broad framework that charts general directions for the Nation. Advance targeting, viewed this way, does not mean the making of specific, hard-and-fast spending or taxing decisions for the future. Instead it means the making of plans.

Because advance targets are just that--targets or plans--and not spending ceilings or revenue floors, they do not bind future Congresses. The Congress would always retain the power to amend those targets. Indeed, it would be surprising if the Congress did not change the targets every year. Thus, the targets established for future years would not be immutable or set in concrete. We envision rolling targets--that is each session of the Congress, besides adding targets for an additional future year, would revise as necessary the previously set targets for the intervening years.

Besides retaining flexibility for future Congresses, rolling targets are necessary because of our imperfect knowledge about the economy. Beyond eighteen months into the future our forecasts of the economy's behavior became very problematic. This should not, however, prevent us from charting general directions for federal activities.

Although fiscal policy will necessitate continual re-adjustments of the targets, many of the broad outlines will remain. We feel it is far better to make a plan and change it, than not to have made a plan at all.

As to the specifics of advance targeting, our report recommends that the Budget Committee formulate, and that the Congress adopt, a plan for voting on advance budget targets, with the eventual goal of annually adopting targets not only for the current budget year but also for the four following years. One possible implementation schedule would permit the Congress to move into an advance targeting process in a series of stages over a three-year period. The Congress could start year after next by stating targets for two years, fiscal years 1980 and 1981. We recommend that the Administration be requested to submit budget proposals for two years, as President Ford did in his last budget submission. Similarly, under this plan the March 15 reports from the standing committees would cover their views and budget recommendations for two years.

In succeeding years the Congress could add third, fourth, and fifth year targets to its budget resolutions. Eventually, the Congress would focus mainly on the fifth

year target issues, shaping its current year taxing and spending decisions to fit the fifth year target decisions it has made.

Mr. Chairman, this concludes my statement this morning. I will be happy to answer any questions you or Members of the Committee may have.

Thank you.